Economic Update

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International Scene

Fed cuts rates again, while UK faces crucial election to resolve Brexit

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Highlights

- **Financial markets were positive in October as the US and China closed in on a tentative 'phase one' trade agreement, the US Fed cut interest rates again and hopes increased that the Brexit issue – while ongoing – may be closer to a resolution.**
- **Following the latest rate cut, US Fed chair Jay Powell indicated that the 'mid-cycle adjustment' in rates is now over. US GDP growth came in at 1.9% in 3Q19, only a fraction below Q2, though investment and exports were weak.**
- **Eurozone growth was a modest 0.2% q/q in 3Q19 but unchanged from Q2. The UK faces a general election that could define the Brexit issue with PM Johnson looking to pass his new deal with the EU if he secures a parliamentary majority.**

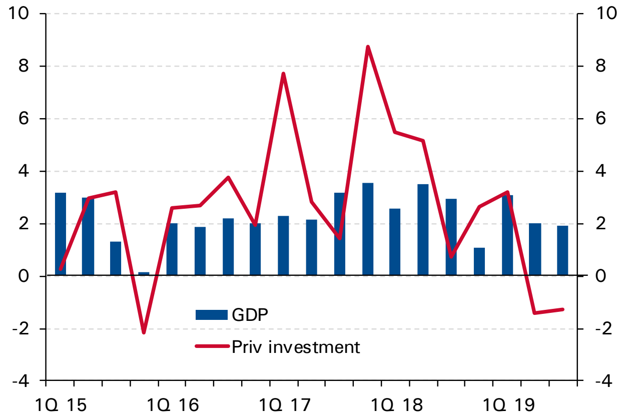
Financial markets saw a second successive positive month in October as the US and China closed in on a tentative 'phase one' trade agreement, the US Fed cut interest rates for a third time since the summer and hopes increased that the Brexit issue – while ongoing – may be closer to a resolution. The IMF revised down its forecasts for world growth this year and next to a moderate 3.0 and 3.4% respectively and warned of downside risks to the outlook, though its more pessimistic outlook had been largely anticipated. Meanwhile Brent crude oil prices were range bound near $60/bbl following September's volatility linked to the drone attacks on Saudi oil facilities.

US GDP growth steady in Q3 as Fed puts policy in neutral

US economic data continues to come in mixed, but mostly points to moderate growth going forward with risks to the downside. GDP in 3Q19 was actually slightly stronger than expected at an annualized 1.9% (consensus 1.7%), down only fractionally from 2.0% in Q2 and amid a still strong performance from consumer spending, up 2.9%. (Chart 1.) Meanwhile the labor market remains in decent shape with non-farm jobs rising a solid 128,000 in October and wage growth unchanged at 3.0% y/y. However forward-looking indicators remain in the doldrums, reflecting a loss of momentum compared to last year, the trade war impact, and worries over the aging economic cycle. PMI measures for both manufacturing and services, at 51 in October, indicate barely any growth at the start of 4Q19, while components of GDP sensitive to business confidence and the external sector (investment and exports) were weak in Q3. Early projections by the Atlanta and New York Feds have growth slowing to a range of 0.8-1.1% in 4Q19.

Chart 1: US GDP

(% q/q annualized)

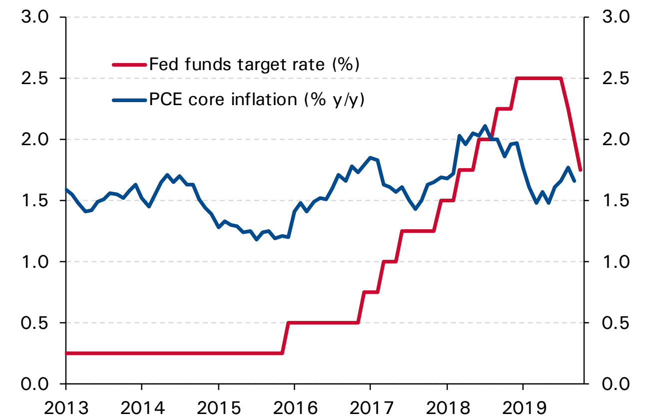


Source: Refinitiv

In order to mitigate the downside risks to growth, the Federal Reserve as expected cut interest rates by 25 bps for the third time since July, leaving the Fed Funds target range at 1.50-1.75%. (Chart 2.) But the cut was considered 'hawkish', with two of 10 members again voting to leave policy on hold and post-meeting comments by Fed chair Jay Powell indicating that what he has termed a 'mid-cycle adjustment' in rates is now over, implying no further cuts ahead. Futures markets expect rates to be on hold until next spring, and a 73% chance of at least one cut by end-2020.

Aside from the prospects for economic activity, another thing that concerns the Fed is the weak outlook for inflation, which fell back to 1.7% y/y in September on its preferred core Personal Consumption Expenditure (PCE) measure, from 1.8% in August and below the 2% target for the ninth consecutive month. Surveys show inflation expectations dropping and prospects will weaken further it tariff hikes fail to materialize as part of a temporary US-China trade deal, which may be close. The Fed worries about Japan-style deflation risks, which are also now threatening the Eurozone; given the apparent insensitivity of inflation to ultra-low interest rates in recent years, a further fall in inflation could be tough to address.

Chart 2: US interest rates and inflation



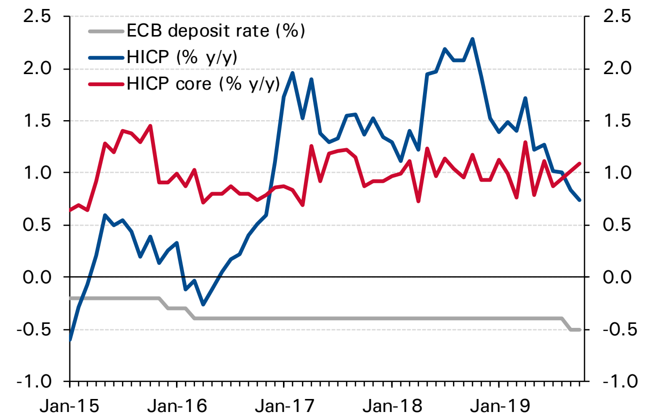
Source: Refinitiv Note: shows upper end of the Fed's target range.

Eurozone growth still weak; UK faces crucial election

The trade war and Brexit worries continue to drag on growth in the Eurozone. GDP growth in 3Q19 came in slightly better than expected but still modest at 0.2% q/q, unchanged from Q2, with growth in France and Spain holding at 0.3% and 0.4% respectively. Figures for Germany are not yet available but are expected to show a second consecutive quarterly decline in output, indicating recession. The German manufacturing PMI – particularly sensitive to external weakness – remained deep in contraction territory at 42.1 in October despite edging up fractionally from September's 10-year low, with firms forced to slash both employment and prices amid weak order books. Economic sentiment in the region also fell to a four-year low, with signs that pessimism in industry is chipping into until-now more resilient services and consumer sectors.

Following public divisions over recent stimulus measures, policymakers at the European Central Bank presented a more united front at their October meeting, which was Mario Draghi's last as bank president before being replaced by Christine Lagarde on November 1st. Having cut its deposit rate to -0.5% in September, the bank restarted its asset purchase program at a rate of €20 billion per month from November, and pledged not to raise rates until Eurozone inflation – which declined to an almost three-year low of 0.7% in October – has "robustly" returned to its near-2% target. (Chart 3.) Meanwhile, given a combination of new ECB leadership and continued doubts within the bank about policy efficacy, the barrier to additional stimulus has likely been raised following Draghi's departure. Lagarde looks set to advocate for a more expansionary fiscal stance from national governments with policy space in order to support economic growth, but could also look to shift the bank's policy tools and objectives in light of a persistent inflation undershoot.

Chart 3: Eurozone inflation and interest rates



Source: Refinitiv

In the UK, prime minister Boris Johnson managed to secure a new Brexit deal with the EU, but was forced to request a three-month extension beyond the scheduled end-October leaving date after parliament refused to ratify the agreement to an accelerated timetable. Faced with further attempts to water down or obstruct his deal, Johnson called a general election that MPs had long resisted in the hope of changing the parliamentary dynamic. While his Conservative party is ahead in the polls by a decent margin, the December election – the UK's first December poll since 1923 – could yet backfire on the PM given scope for the polls to narrow during the campaign and the prospect of tactical voting by the public across party lines reflecting their views on Brexit. Moreover, given opposition to his Brexit policy among other parties, Johnson is also unlikely to be able to form a coalition government if he fails to win an outright majority. However a decisive win for Johnson that sees his deal pass could lift the cloud of uncertainty hovering over the UK economy and provide a boost for Europe's economy overall.

Bank of Japan tweaks forward guidance

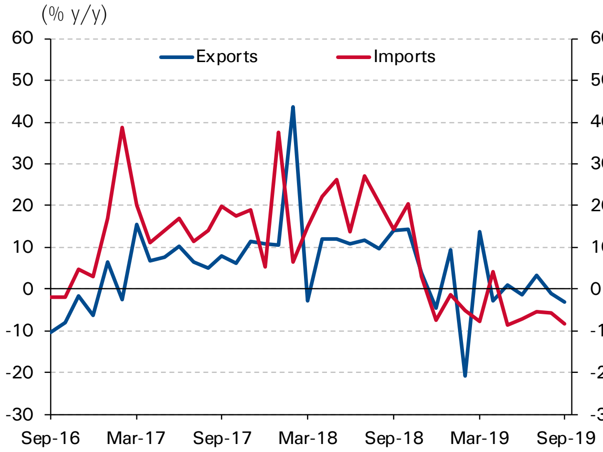
The Bank of Japan left monetary policy broadly unchanged last month but tweaks to its forward guidance suggest that it is willing to pull its policy rate further into negative territory in a bid to prop up the economy and ultimately reach its (elusive) 2% inflation target. The economy remains weighed down by weaker global demand, not least because of ongoing US-China trade tensions. Indeed, fresh data showed exports falling for the 10th straight month in September by a larger-than-expected 5.2% y/y. Meanwhile imports also fell for the fifth consecutive month, by 1.5%, pointing to continued weakness in domestic demand; although retail sales growth surged to an almost six-year high in September, this was mostly driven by front-loading of spending ahead of the October sales tax hike which could reverse in 4Q19. Against this backdrop, the government downgraded its assessment of the economic climate for the third time this year in October, raising the stakes for additional easing in the months to come.

Weakness in Chinese trade data persists

China's external sector continues to face headwinds as the effects of trade tensions with the US are compounded by a broad slowdown in the global economy. Chinese exports declined for the second straight month in September, but at a sharper 3.2% y/y. (Chart 4.) Imports also fell at a faster 8.5% on weakness in the domestic economy. Trade talks with the US appear to be closing in on a 'phase one' deal, the details of which have yet to be disclosed. Meanwhile, private and official PMI manufacturing data continued to diverge in October: the private PMI index showed activity expanding at its fastest pace in almost three years, but the official PMI pointed to a slightly bigger contraction. The divergence could be due to smaller private companies benefiting more from the government's pro-growth measures of recent months. Separately, the yuan appreciated for the second straight month in October, with the central rate ending the month up 0.3% at RMB7.05/US$1 amid trade talk progress.

Chart 4: Chinese goods trade

(% y/y)



Source: Refinitiv

Oil prices range bound in October

Brent crude moved sideways through most of October, trading in a narrow range of $58-62/bbl and finishing the month down a modest 0.9% m/m at $60.2/bbl. (Chart 5.) With Saudi crude production restored to 'normal' levels in October after the drone strike on Abqaiq/Khurais, any lingering geopolitical risk premium appeared to vanish, replaced once more by anxieties over faltering global economic growth, the dominant theme of 2019.

Movements in Brent in October largely stemmed from US-China trade developments and US crude stock levels. The International Energy Agency trimmed its oil demand growth forecasts for 2019 and 2020 by 0.1 mb/d to 1.0 mb/d and 1.2 mb/d, respectively. On the supply side, OPEC and its partners were tight-lipped about further production cuts, preferring to wait until December's ministerial meeting before making any announcements – though we believe further cuts are unlikely. Meanwhile US crude production reached a new high of 12.6 mb/d in October, even while the rig count continued its 2019 decline.

Chart 5: Brent crude oil price

($ per barrel, end of month)

Source: Refinitiv

GCC developments

In its pre-budget statement, the Saudi ministry of finance lowered its forecasts for revenue, expenditure and economic growth. The budget deficit for 2019 is now seen at 4.7% of GDP this year (4.2% previously), and is projected to widen to 5.0% of GDP in 2021 (3.7% before). The changes reflect both lower oil prices and lower royalty rates on Aramco's oil sales, which necessitate lower budgeted spending. GDP growth forecasts were also cut for 2019 to 0.9% (2.6% before) and for 2020-22 to 2.2-2.3% per year (2.7-2.8% before). Saudi Aramco, meanwhile, published its intention to float, with the firm expecting a valuation close to $2 trillion when it lists on the Riyadh stock exchange while investors are estimating a valuation in the $1.2-2 trillion range.

Most GCC countries followed the US Federal Reserve in cutting benchmark interest rates by 25 bps in October. Finally, GCC countries did well in both the latest World Bank Doing Business and the latest World Economic Forum Competitiveness rankings. Saudi Arabia's Doing Business rank jumped 30 places to 62, while the UAE still leads the way in the Gulf with a rank of 16. Kuwait's score in both metrics also significantly improved.

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